

**DEPARTMENT OF STATE REVENUE  
LETTER OF FINDINGS NUMBER: 00-0272  
Adjusted Gross Income Tax—Business/Non-business Income  
Tax Administration—Penalty  
For Tax Years 1992-1994**

NOTICE: Under Ind. Code § 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

**ISSUES**

**I. Adjusted Gross Income Tax—Business Versus Non-Business Income: Gains from the Sale of Stock**

<b><u>Authority:</u></b>	<b>IC § 6-3-1-20</b>	<b>45 IAC 3.1-1-29</b>
	<b>IC § 6-3-1-21</b>	<b>45 IAC 3.1-1-30</b>
	<b>IC § 6-8.1-5-1(b)</b>	<b>45 IAC 3.1-1-31</b>

*May Department Stores v Indiana Department of Revenue*, 749 N.E.2d 651 (Ind.Tax, 2001)

Taxpayer protests the auditor's reclassification of gains from the sale of stock in foreign corporations from non-business to business income.

**II. Adjusted Gross Income Tax—Business Versus Non-Business Income: Litigation Settlements**

Taxpayer protests the auditor's reclassification of litigation settlement amounts from non-business to business income.

**III. Adjusted Gross Income Tax—Business Versus Non-Business Income: Joint Venture**

<b><u>Authority:</u></b>	<b>IC § 6-3-1-19</b>
	<b>IC § 6-2.1-5-10</b>

Taxpayer protests the auditor's reclassification of taxpayer's interest in a joint venture from non-business to business income.

**IV. Adjusted Gross Income Tax—Business Versus Non-Business Income: Interest Income and Management Fees**

Taxpayer protests the auditor's reclassification of interest income and income from management fees from non-business to business income.

**V. Tax Administration—Penalty**

**Authority: IC § 6-8.1-10-2.1**

**45 IAC 15-11-2**

Taxpayer protests the imposition of the 10% negligence penalty.

**STATEMENT OF FACTS**

Taxpayer is a diversified, worldwide producer of chemical and related products in two different industries, chemical specialties and food and functional products. Taxpayer sells its products directly to customers from plants and warehouses. Taxpayer also uses distributors to sell its products, particularly in markets outside the United States. During the audit period, taxpayer had a chemical manufacturing plant in Indiana. Taxpayer closed this plant in 1995. Taxpayer had no other Indiana facilities during the audit period.

Taxpayer produces rosin and resins for the writing, printing, tissue, towel and packaging markets; fibers and textile yarns for the hygiene, furnishings, and auto markets; rosin, hydrocarbons, resins and peroxides for the tape, label, packaging, ink, insulation, construction and household products markets. Taxpayer also produces celluloses for the paint, adhesives, cosmetics, pharmaceuticals, food and beverage, oil well and smokeless powder industries. Taxpayer also produces food gums, aroma chemicals, and photopolymer resins.

The audit made numerous adjustments to taxpayer's gross and adjusted gross income tax. Taxpayer protested the following: the reclassification of the following items from non-business to business income: gains from the sale of stock in foreign corporations; litigation settlements; interest in a joint venture; interest income and management fees. Taxpayer also protested the 10% negligence penalty. Additional facts will be added as necessary.

**I. Adjusted Gross Income Tax: Business/Non-business Income: Gains from sale of Stock**

**DISCUSSION**

Taxpayer protests the recharacterization of gains from the sale of stock in foreign corporations from non-business to business income.

Under IC § 6-8.1-5-1(b), a "notice of proposed assessment is *prima facie* evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made."

IC § 6-3-1-21 defines “nonbusiness income” as “all income other than business income.” *See also*, 45 IAC 3.1-1-31. Secondly, IC § 6-3-1-20 defines “business income” as “income arising from transactions and activity in the regular course of the taxpayer’s trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitutes integral parts of the taxpayer’s regular trade or business operations.” *See also*, 45 IAC 3.1-1-29:

“Business Income” Defined. “Business Income” is defined in the Act as income from transactions and activity in the regular course of the taxpayer’s trade or business, including income from tangible and intangible property if the acquisition, management, or disposition of the property are integral parts of the taxpayer’s regular trade or business.

Nonbusiness income means all income other than business income.

The classification of income by the labels occasionally used, such as manufacturing income, compensation for services, sales income, interest, dividends, rents, royalties, gains, operating income, non-operating income, etc., is of no aid in determining whether income is business or nonbusiness income. Income of any type or class and from any source is business income if it arises from transactions and activity occurring in the regular course of a trade or business. Accordingly, the critical element in determining whether income is “business income” or “nonbusiness income” is the identification of the transactions and activity which are the elements of a particular trade or business.

The Indiana Tax Court in *May Department Stores v. Indiana Department of Revenue*, 749 N.E.2d 651 (Ind. Tax 2001), 2001 Ind. Tax Lexis 32, clarified the statutory and regulatory language cited above, and outlined the transactional and functional tests the Department must apply to distinguish business from non-business income.

In *May*, the Indiana Tax Court construed the definitions of “business income” under IC §§ 6-3-1-20 and 6-3-1-21 (non-business income). As the court noted, the “distinction between business and nonbusiness income is important in calculating a taxpayer’s tax liability . . . whether income is deemed business or nonbusiness income determines whether it is allocated to a specific state or whether it is apportioned between Indiana and other states wherein the taxpayer is conducting its trade or business.” *May*, 749 N.E.2d 651 at 656. The court found that “. . . in passing IND. CODE § 6-3-1-20, the General Assembly provided two tests for defining business income . . . the ‘transactional’ and ‘functional’ tests.” *Id.* at 662. The court goes on to say that IC § 6-3-1-20 “requires that not only the property’s disposition but also its acquisition and management must be integral parts of the taxpayer’s regular trade or business.” *Id.* at 664.

Under the transactional test, the nature of the particular transaction generating the income is the controlling factor the Department uses to identify business income pursuant to *May*. Three

considerations enter into the Department's identification process: the frequency and regularity of similar transactions; the former practices of the business; and taxpayer's subsequent use of the income.

Under the functional test, gain from the disposition of a capital asset is considered business income if the asset disposed of was used by the taxpayer in its regular trade or business operations. According to the court in *May*, the regulation found at 45 IAC 3.1-1-30 requires the Department to consider the following in determining the scope of a taxpayer's trade or business:

1. The nature of taxpayer's trade or business.
2. The substantiality of the income derived from activities and transactions and the percentage of that income which forms taxpayer's total income for a given tax period.
3. The length of time the property producing income was owned by taxpayer.
4. The taxpayer's purpose in acquiring and holding the property producing income.

Under the functional test, the Department must focus on the property being disposed of and the relationship between the property at issue and taxpayer's business operations. The question to be asked is whether the property, its use and /or disposition, forms an integral part of taxpayer's business.

Taxpayer owned 50% of the stock of a Japanese corporation, and 62% of the stock of an Australian corporation, allegedly holding both stock portfolios as investments. Taxpayer sold all of its stock in the Japanese corporation in 1992 and all of its stock in the Australian corporation in 1993. Taxpayer's protest stated that taxpayer's interests in these corporations were merely investments. At the hearing, taxpayer's representative argued that taxpayer did not have any of the legal hallmarks of a unitary relationship with either corporation; Japanese and/or Australian nationals staffed each, and each corporation was organized and managed pursuant to Japanese and/or Australian laws and customs. Taxpayer also argued that the activities of these two corporations had nothing to do with the Indiana chemical manufacturing plant's activities. The Indiana plant, until its closure in 1995, manufactured packaging materials, such as cellophane, for CD cases, VHS tape boxes, and the like.

In assessing whether or not income is business or non-business, the Department looks at a taxpayer's entire business operations. In this particular taxpayer's case, its worldwide diversity of interests and its prominence in chemical manufacturing in particular have created a sufficient connection between the two foreign corporations and the Indiana chemical manufacturing plant.

Taxpayer's reliance on the absence of indicators for a unitary relationship between itself and the two foreign corporations is misplaced. It is immaterial and too formulaic that foreign nationals staffed the corporations and that they were organized pursuant to the laws of the country where each was located. A sweeping generalization that the percentage of stock ownership was for investment purposes only does not clear the bar of the Audit Division's finding that the gain from the stock sale was business income. Under the totality of the circumstances—taxpayer and

the two foreign corporations are all chemical manufacturers, the Japanese corporation's name was hyphenated with taxpayer's, the lack of information provided about the transactions surrounding the acquisition, management, and disposition of the funds acquired in the sale, and taxpayer's failure to explain how 50% and 62% ownership percentages do not constitute management presence—the Department finds that the gain from the sale of stock is business income.

### **FINDING**

Taxpayer's protest concerning the reclassification of gain from the sale of stock in foreign corporations from non-business income to business income is denied.

## **II. Adjusted Gross Income Tax—Business versus Nonbusiness Income: Litigation Settlements**

### **DISCUSSION**

Taxpayer protests the reclassification of litigation settlement amounts from non-business to business income. *See* legal discussion *supra*, under Issue I. During the tax years at issue, specifically 1993, there were three areas of litigation that produced substantial dollar settlements for taxpayer. One of the suits was an insider trading action against a brokerage house and a bank. Taxpayer sued both institutions for damages taxpayer incurred as a result of the unlawful disclosure of information causing the target corporation's stock price to increase. Taxpayer has failed to provide sufficient information, i.e., solid facts, about the business of the target company, the purpose behind the acquisition, and how the target company would have functioned within taxpayer's overall business operations. Since taxpayer has failed to meet its burden of proof on this issue, the Audit Division's proposed assessment stands.

The second legal action concerned a patent infringement suit. Taxpayer's patent was for systems and processes involved in the manufacturing of polymers. Taxpayer testified that the settlement payment was "over and above the main object of the lawsuit, which was to stop" the defendants from infringing on taxpayer's patent. Since taxpayer is in the business of manufacturing polymers, any legal action taken to protect that manufacturing process, and any monies received due to that protective legal action, is business income and directly related to taxpayer's operations. Taxpayer's protest on this issue is denied.

The third legal action concerned the specific performance of a prime contractor in a government contract. Taxpayer was the subcontractor to aid development of the Titan IV rocket. The prime contractor controlled everything about the project, and a dispute arose about cost reimbursements. Taxpayer sued the prime contractor in the state where all work was performed, Utah. The litigation settled when the prime contractor agreed to pay taxpayer's costs pursuant to the contract, taxpayer's contract price for its work, plus damages for losses incurred as a result of untimely cost reimbursements. Since development of rocket components is very closely tied to chemical manufacturing, any monies gained through a protective contract enforcement action at law would be business income to taxpayer. Nonpayment injures business operations;

successfully seeking legal redress against a breaching or non-performing party to a contract necessarily results in business income. Taxpayer's protest on this issue is denied.

### **FINDING**

Taxpayer's protest concerning the reclassification of dollar amounts received in settlement of litigation from non-business to business income is denied.

### **III. Adjusted Gross Income Tax—Business versus Nonbusiness Income: Joint Venture**

### **DISCUSSION**

Taxpayer protests the reclassification of its interest in an alleged joint venture from non-business to business income. Taxpayer entered into an arrangement with another company as subcontractors to a third to develop and manufacture rocket components. All activities associated with this effort took place in Utah. The Indiana Code includes joint ventures in its definition of partnerships at IC § 6-3-1-19. IC § 6-2.1-5-10 imposes on such entities the following duty:

- (a) Every individual, partnership, corporation . . . shall file an information return with the department if he has the control or custody of, receives, or makes payment of:
  - (1) dividends of six hundred dollars (\$600) or more;
  - (2) interest of six hundred dollars (\$600) or more;
  - (3) rents, premiums, annuities, compensations, or other fixed or determinable annual or periodic amounts, which are subject to the tax imposed by this article and must be reported by the taxpayer under federal income tax law;
  - (4) salaries, wages, or compensation of one hundred dollars (\$100) or more;which are paid, payable, or credited to another taxpayer and are subject to the gross income tax.

There is no evidence that taxpayer had ever filed such information returns. As noted by the auditor, taxpayer, at a strategic point in the audit process, refused to provide any information or documents supporting its position that income from the joint venture was non-taxable in the state of Indiana. The manufacturing of rocket components is very closely tied to chemical manufacturing. The assessment was based on the best information available at the time of the audit; taxpayer offered nothing at the hearing to overcome the presumption that the assessment was and is correct. Taxpayer has failed to meet its burden of proof on this issue.

### **FINDING**

Taxpayer's protest concerning the reclassification of taxpayer's interest in a joint venture from non-business to business income is denied.

**IV. Adjusted Gross Income Tax—Interest Income and Management Fees****DISCUSSION**

Taxpayer protests the reclassification of interest income and income from management fees from non-business to business income. The interest payments were payments on long-term loans to entities in which taxpayer held minority stock interests. These entities were not functional parts of taxpayer's business; the transactions themselves were made for investment purposes. Pursuant to the legal discussion set forth in Issue I *supra*, taxpayer did not receive business income. Taxpayer's protest on this issue is sustained.

The other issue concerns management fees from one of taxpayer's subsidiaries. This subsidiary manages properties of aqueous systems and has plants in Missouri, New Jersey, Texas, Virginia, and several European countries. Taxpayer did not provide sufficient facts about what the subsidiary does, nor what the properties consist of, and their purpose, for the Department to discern the exact nature of the management fees and the services taxpayer provided to the subsidiary. Therefore, taxpayer has not met its burden of proof on this issue. Taxpayer's protest on this issue is denied.

**FINDING**

Taxpayer's protest concerning the reclassification of interest income from non-business to business income is sustained. Taxpayer's protest concerning the reclassification of management fees from non-business to business income is denied.

**V. Tax Administration—Penalty**

Taxpayer protests the imposition of the 10% negligence penalty. Taxpayer argues that its failure to pay the appropriate amount of tax due was based solely on taxpayer's interpretation of the relevant statutes, regulations, and case law.

Indiana Code Section 6-8.1-10-2.1(d) states that if a taxpayer subject to the negligence penalty imposed under this section can show that the failure to file a return, pay the full amount of tax shown on the person's return, timely remit tax held in trust, or pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect, the department shall waive the penalty. Indiana Administrative Code, Title 45, Rule 15, section 11-2 defines negligence as the failure to use reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence results from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by Indiana's tax statutes and administrative regulations.

In order for the Department to waive the negligence penalty, taxpayer must prove that its failure to pay the full amount of tax due was due to reasonable cause. Taxpayer may establish reasonable cause by "demonstrat[ing] that it exercised ordinary business care and prudence in carrying or failing to carry out a duty giving rise to the penalty imposed. . . ." In determining whether reasonable cause existed, the Department may consider the nature of the tax involved, previous judicial precedents, previous department instructions, and previous audits.

Taxpayer's failure to pay the proper amount of adjusted gross income tax was based on its interpretation of the difference between business and non-business income under United States Supreme Court case law concerning issues of nexus and sufficient minimum contacts with Indiana—i.e., Indiana's power to tax. Taxpayer should have ascertained what Indiana's statutes, regulations, and case law delineated at the time of the failure to pay the tax. All the *May* case, *supra*, did was pull together the threads of the business versus non-business tangle into one piece of fabric. Indiana's statutes and regulations regarding business versus non-business income are well within the Constitutional strictures of the cases taxpayer cited in the protest of these proposed assessments.

Given the totality of the circumstances, the Department finds taxpayer was negligent in carelessly construing the applicable statute and regulations. A careful and thoughtful review would have revealed taxpayer's duty to pay the adjusted gross income tax this Letter of Findings has determined taxpayer must pay.

### **FINDING**

Taxpayer's protest concerning the abatement of the 10% negligence penalty is denied.